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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SIXTH APPELLATE DISTRICT

NICHOLAS J. DALIS, as TRUSTEE, etc., Plaintiff and Appellant, v. ELI REINHARD, Defendant and Respondent.	H031637 (Santa Clara County Super. Ct. No. CV028388)

In October 1993, defendant Eli Reinhard purchased all of the stock in Garden City, Inc. (Garden City) a privately held corporation, from the Garden City Irrevocable Trust (the Trust). Garden City filed for bankruptcy in July 1998. In 2004, plaintiff, the trustee of the Trust, filed an action on behalf of the Trust against Reinhard. The Trust alleged numerous causes of action including breach of contract and breach of the implied covenant of good faith and fair dealing. The Trust also alleged a declaratory relief cause of action asserting the unconscionability of the nonrecourse provision of a promissory note executed by Reinhard in favor of the Trust in exchange for Garden City's stock.

The superior court sustained Reinhard's demurrer without leave to amend to the breach of contract and breach of the implied covenant causes of action. The Trust's remaining causes of action were tried to the court. The trial court concluded that the nonrecourse provision of the promissory note was not unconscionable. It issued a

declaratory judgment stating that Reinhard had defaulted on the note but could not be held personally liable by the Trust. The court also awarded Reinhard his attorney's fees.

On appeal, the Trust contends that the superior court erred in sustaining the demurrer without leave to amend because the Trust adequately pleaded contract and implied covenant causes of action. It also contends that the trial court erred in ruling that the nonrecourse provision of the note was not unconscionable. We conclude that the superior court properly sustained the demurrer without leave to amend and that the trial court correctly concluded that the note's nonrecourse provision was not unconscionable. We affirm the judgment and the attorney's fees order.[1]

I. Factual Background

A. Pre-Contract

Garden City, which was founded in 1946 and incorporated in 1974, operates a 40-table cardroom in San Jose. Garden City owns no real property. Its value as a business, and the value of its stock, is entirely dependent on its gaming license, and it otherwise has "little if any value as a going concern."

Garden City's shareholders were the subjects of a lengthy criminal investigation. In 1990, Garden City's shareholders began seeking a buyer for Garden City. In 1992, Garden City and its shareholders entered into an agreement with Garden City's landlord in which Garden City agreed to repurchase the landlord's Garden City shares for $1 million, and Garden City and its shareholders agreed to pay the landlord $11 million to settle a lawsuit the landlord had brought against them. Garden City continued to operate subject to its lease from the landlord even though this lease was "financially

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[1] The Trust's challenge to the attorney's fees order depends completely upon the validity of its challenge to the judgment. As the Trust's challenge to the judgment fails, its challenge to the order must also fail.

oppressive," because the City of San Jose (the City) would not permit Garden City to move its business location unless there was a condemnation proceeding.

In January 1993, the criminal investigation was completed. As a result, the City's Chief of Police (the Chief of Police) imposed a $5 million fine on Garden City and ordered that each and every Garden City shareholder "completely divest him or herself of all stock in The Garden City" within 270 days. The Chief of Police also mandated that the "transferee stockholders" who purchased the stock be "persons of good reputation, unrelated to and fully independent of the current stockholders and subject to the approval of the Chief of Police." In February 1993, Garden City's shareholders pleaded guilty to felony tax evasion and other criminal offenses. The State of California (the State) thereafter prohibited Garden City's shareholders from being involved in the management of Garden City and required them to divest themselves of their stock by October 18, 1993.

In June 1993, the Trust was created, and the shareholders transferred 100 percent of the stock in Garden City to the Trust. Garden City's former shareholders, now the Trust's beneficiaries, and the Trust continued to make "every effort" to sell Garden City. This effort was made more difficult by the fact that any buyer of Garden City's shares had to be licensed by both the City and the State. The Trust's beneficiaries were not permitted to have any "participation in profitability" of Garden City after the required sale of the shares. While the Trust was attempting to sell the shares, the City authorized another cardroom to open a substantially expanded operation in a new location, which was expected to substantially reduce Garden City's revenues. The Trust's beneficiaries still owed Garden City's landlord $10 million under the 1992 settlement agreement, and they also owed millions of dollars in taxes. Their objective was to obtain funds from the sale of Garden City's stock to satisfy these obligations.

In July 1993, the Trust engaged in negotiations with a prospective buyer during which an offer was made by the prospective buyer and a counteroffer was made by the

Trust. These negotiations did not bear fruit. Reinhard, a real estate developer who had no gaming background, first learned of the Trust's search for a buyer for Garden City from his neighbor, Frank Nicoletti, who was Garden City's attorney. Nicoletti casually suggested that Reinhard buy Garden City. Nicoletti told Reinhard "that he wasn't looking to me to assume a lot of personal liability." Reinhard was not initially interested. Nevertheless, in July or August 1993, the Trust sent to Reinhard and two other prospective buyers "substantially identical" offers to sell the shares of Garden City. Each of these offers proposed that the buyer pay $9 million in cash and provide a $45 million promissory note in exchange for Garden City's stock. The $45 million note would be reduced to $35 million if the buyer did not initiate a public offering of the stock within a certain period.

Reinhard began discussing the matter with the trustee, and he became interested in purchasing Garden City. On August 17, the Trust sent a revised proposal to Reinhard. This proposal contemplated that the buyer would pay $1 million to the City toward Garden City's fine, $9 million in cash, and provide a $45 million promissory note secured by the stock. Again, the promissory note would be reduced by $10 million if there was no public offering of the stock. During an August 1993 telephone conversation with the trustee, Reinhard discussed the terms of a possible offer. On August 27, the trustee wrote a letter to Reinhard setting out the terms as he understood them of Reinhard's potential offer. These terms were $9 million down, a $1 million payment to the City on the fine, and a $35 million note. That same day, the Trust informed Reinhard that it was going to accept an offer on September 2, so all offers had to be received by September 1.

Reinhard was aware of a competing offer from another prospective purchaser. At some point, the trustee told Reinhard that he had received a better offer from this other potential buyer. In fact, the other potential buyer was precluded from buying Garden City because he wanted to use a publicly held corporation to make the purchase, and the law did not permit such a corporation to own the stock of Garden City.

On September 2, Reinhard submitted a proposed letter of intent and an exclusive negotiation agreement. Reinhard's September 2 offer was for $3 million down, a $6 million note that was to be paid off by April 1994, a $17.8 million nonrecourse note, and $1 million toward Garden City's fine to the City. "The [$17.8 million] Note will be nonrecourse against Buyer and the sole recourse of the holder of the Note shall be against the assets of the Company. Buyer shall be personally liable for amounts which have been distributed to Buyer by the Company for payment to Seller on the Note . . . ."

Each and every subsequent proposal and counterproposal provided that the larger or sole promissory note would be nonrecourse. Reinhard and the Trust engaged in a "long, extensive and expensive" due diligence process and contract negotiations during which the Trust, the trustee, and the Trust's beneficiaries were advised by numerous attorneys.

The trustee decided that Reinhard "would be the better buyer for the Trust" as Reinhard's offer was better than that of the competing potential buyer, and the competing potential buyer "was not willing to meet that offer." The Trust did not negotiate with any other potential buyers after September 2. However, the Trust did not accept Reinhard's September 2 offer.

Reinhard submitted another offer on September 15. This offer was similar to his September 2 offer, but the larger nonrecourse note was for $10.2 million, rather than $17.8 million, and bore a higher interest rate. Reinhard's September 15 offer contained the same nonrecourse provision as his September 2 offer. The trustee rejected Reinhard's September 15 offer, but negotiations continued.

On September 19, the Trust submitted a proposal to Reinhard with a total purchase price of $23.4 million. The payment terms presented three alternatives. These alternatives were dependent upon possible settlements with Garden City's landlord and the IRS. The alternative that depended on a settlement with both the landlord and the IRS was similar to Reinhard's September 15 offer but the amount of the larger

nonrecourse note was $14.4 million, rather than $10.2 million. The smaller $6 million note was "fully recourse as to Maker" and was also secured by the stock. The larger $14.4 million note was "nonrecourse against Maker and the sole recourse of the holder of this Note shall be against the Collateral [shares]" except that "Maker shall be personally liable only for an amount, if any equal to the Excess Distributions through the date in question." The other two alternatives were substantially different.

The Trust continued to propose similar terms in a series of proposals over the next week. These proposals contemplated that Reinhard "will take care of" the Trust beneficiaries' liability to the landlord under the 1992 settlement agreement, but this obligation was "nonrecourse to [Reinhard]: the obligation is to be satisfied only out of Garden City's assets." In late September, the Trust learned that Garden City's "net worth" on its most recent balance sheet was "materially less" than had been previously disclosed to Reinhard.

By the end of September, Reinhard and the trustee had settled on a larger nonrecourse note with no cash upfront. The amount of the nonrecourse note did not significantly change during the final negotiations. Reinhard had not agreed at that point to personally pay Garden City's obligation to its landlord under the 1992 settlement.

On October 1, Reinhard submitted a proposed stock purchase agreement and a proposed promissory note. This proposal provided for no cash down, a $1 million payment to the City, and a nonrecourse note for the entire $23.4 million purchase price. It required Reinhard to either indemnify the Trust beneficiaries from their liability to the landlord under the 1992 settlement agreement or to obtain the landlord's release of the beneficiaries from that obligation. The October 1 proposed agreement explicitly provided that Reinhard would have "No Personal Liability." The October 1 agreement allowed Reinhard to walk away from the deal any time before October 11. An October 7 revision of the October 1 agreement was substantively similar but allowed Reinhard to walk away from the deal up to October 13.

B. The Contract and The Promissory Note

The final revised stock purchase agreement (the SPA)[2] was dated October 13 and executed by the Trust's beneficiaries on October 15, which was the last possible date for the Trust to complete the sale before the divestiture deadline. The only major difference between the SPA and its accompanying promissory note (the Note), and the October 1 and October 7 agreements and their accompanying notes, was that the SPA and the Note now included a "put option." The "put option" gave the Trust the right to elect, within 30 days of the execution of the Note, to require Reinhard to purchase up to 60 percent of the outstanding principal of the Note for half of its value. 60 percent of the principal of the Note was $14,040,000, so the Trust had the right to require Reinhard to purchase 60 percent of the principal of the Note by paying to the Trust $7,020,000, which would reduce the Note's principal amount to $9,360,000. If the Trust so elected within the prescribed period, Reinhard was required to pay that sum on April 8, 1994.

The "put option" was added to the SPA at the behest of one of the Trust's attorneys to cover the tax liability of the Trust's beneficiaries. The SPA also differed slightly from the two earlier versions in that it explicitly required Reinhard to indemnify the Trust beneficiaries for any liability to the landlord under the 1992 settlement agreement. The SPA's payment terms required Reinhard to personally provide $1 million to be paid toward Garden City's fine to the City and to provide the Trust with a $23.4 million nonrecourse promissory note secured by Garden City's stock.

Reinhard agreed in the SPA to 13 express covenants.[3] The SPA provided that it was "the entire agreement among the parties, and supersedes any and all prior negotiations, understandings, and agreements among the parties, relating to the subject matter hereof, and there are no representations, warranties, or commitments except as set

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[2] The SPA was entitled "Second Restated and Amended Stock Purchase Agreement."

[3] It is undisputed that Reinhard did not breach any of these express covenants.

forth herein." Section 18.14 of the SPA was entitled "No Personal Liability." This section, which was identical to the corresponding provisions in the October 1 and October 7 proposed agreements, provided: "Buyer shall assume no liabilities of the Company and shall have no obligation to contribute capital to the Company, other than as set forth in Section 4 [requiring Reinhard to pay $1 million of the $5 million fine]. Buyer shall be personally liable only for amounts which have been distributed to Buyer by the Company for payment to seller on the Note, as provided in the Note."[4] The SPA contained an attorney's fees clause.

The SPA was executed at the same time as the Note, the Pledge Agreement, and the Collateral Agent Agreement. Reinhard agreed in the Note to pay the Trust $23.4 million plus interest on the unpaid principal balance. The Note was secured by "the Collateral pursuant to the Pledge Agreement." The Pledge Agreement stated that Reinhard had "agreed to pledge to [the Trust] the Shares to secure [his] obligations under the Note." "[T]he Shares shall be held by Collateral Agent . . . for the benefit of [the Trust] as security for the Note." Both the Note and the Pledge Agreement contained attorney's fees clauses. The Collateral Agent Agreement provided that John Hopkins would serve as the Collateral Agent and hold the shares.

Section 2 of the Note was entitled "Nonrecourse Note." This section provided: "(a) Except as otherwise provided in paragraph (b) of this section 2, this Note is nonrecourse against the Maker [Reinhard] and the sole recourse of the Trust shall be against the Collateral. In the event the Trust shall at any time take action to enforce the collection of the indebtedness evidenced by this Note, the Trust shall proceed to foreclose under or otherwise enforce the Pledge Agreement (and no deficiency judgment shall be sought in connection with any such foreclosure) instead of instituting suit upon this Note

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[4] It was undisputed that no sums were ever distributed to Reinhard for payment to the Trust under the Note.

or any covenant hereof. If as a result of such foreclosure and sale of the Collateral under the Pledge Agreement, a lesser sum is realized therefrom than the amount then due and owing under this Note and the Pledge Agreement, Maker shall have no personal liability therefor and the Trust will never institute any action, suit, claim or demand at law or in equity against Maker for or on account of such deficiency; provided however that Maker shall be personally liable for the amounts described in paragraph (b) of this Section 2. [¶] (b) Maker shall be personally liable only for amounts, if any, distributed to Maker by [Garden City] for payment to the Trust on this Note, if Maker fails to make such payments to the Trust. If [Garden City] makes a distribution to Maker, and Maker fails to make a principal or interest payment then due to the Trust under the terms of this Note, Maker shall be personally liable to the extent of the distribution so received. For purposes of this Section 2(b), the terms 'amounts distributed to Maker' shall not include amounts which are distributed to the Collateral Agent . . . but are not distributed to Maker."

C. Post-Contract

The $9 million obligation to the landlord under the 1992 settlement agreement was promptly satisfied by Reinhard after the sale of the stock. The Trust timely exercised the "put option", and Reinhard paid the Trust $7,020,000 in April 1994 as provided in the Note, thereby reducing the principal amount of the note by $14,040,000. Garden City filed a Chapter 11 bankruptcy petition in July 1998.[5] Reinhard never received any distributions from Garden City for payment to the Trust under Section 2(b) of the Note.

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[5] The bankruptcy reorganization plan apparently provided for the cancellation of the shares held by the Collateral Agent.

II. Procedural Background

This action was initiated in October 2004. The operative pleading is the Trust's first amended complaint, which alleged 13 causes of action, only three of which are at issue on appeal.

The Trust's first cause of action sought a declaratory judgment that Reinhard could not rely on the nonrecourse provisions of the SPA or the Note because those provisions were unconscionable.

The Trust's eighth cause of action, which sought damages for breach of contract, alleged that Reinhard had breached the SPA in July 1999 by (1) failing "to pay in full and in a timely manner the consideration he promised to plaintiff in exchanged [*sic*] for all of plaintiff's shares of Garden City[,]" (2) paying only $3.5 million of the $5 million fine owed by Garden City to the City, (3) failing to pay Garden City's debts, allowing judgment for nonpayment of rent to be entered against it, and thereby causing Garden City to file for bankruptcy, (4) abandoning Garden City and allowing it to lose its "debtor-in-possession status," (5) failing to provide timely and adequate accountings to the Trust, and (6) failing to cause Garden City to make distributions to the Trust.

The Trust's tenth cause of action, which sought damages for breach of the implied covenant of good faith and fair dealing, alleged that Reinhard had breached the implied covenant by impairing the collateral and making a host of business decisions that resulted in the Trust not receiving distributions of funds from Garden City.

Reinhard demurred to the first amended complaint. He asserted that the Trust could not pursue any of its damages causes of action because it was limited to the remedy of foreclosure on the Garden City shares that were pledged under the Pledge Agreement. Reinhard argued that the Note was not unconscionable, and therefore he could rely on the Note's nonrecourse provision, which precluded the Trust's action against him. He also maintained that the Trust could not state a cause of action for breach of the implied covenant as the SPA and the Note unambiguously expressed the parties' intent.

The superior court sustained the demurrer without leave to amend as to the Trust's eighth and tenth causes of action.[6] Reinhard thereafter filed an answer denying the remaining allegations of the first amended complaint. The court subsequently granted Reinhard's motion for summary adjudication of some causes of action and denied it as to the others, including the first cause of action. The Trust dismissed its judicial foreclosure cause of action. The Trust's remaining six causes of action were determined to be equitable causes of action and were therefore tried to the court.

The unconscionability issue was bifurcated and tried first. The parties stipulated to the admission of all of the documentary exhibits, and they presented the court with a stipulated set of operative facts. The Trust also presented testimony on this issue.

The court issued a declaratory judgment finding that Reinhard was in default on his payment obligations under the Note, and the Trust had properly accelerated the unpaid balance due under the Note. Reinhard therefore owed the Trust under the Note $8,716,500 in unpaid principal, $9,977,082.48 in accrued interest through September 6, 2006, and $2,619.43 in daily interest for every day thereafter. However, the court ruled that Reinhard "has no personal liability for any amount due, owing and unpaid under the Secured Promissory Note." Judgment was entered for Reinhard on all causes of action except for the one declaratory judgment cause of action upon which the court had issued the declaratory judgment. The court declared Reinhard the prevailing party on 12 of the 13 causes of action, and declared the Trust the prevailing party on one cause of action. The court denied the Trust's new trial motion, and the Trust filed a timely notice of appeal from the judgment. The trial court thereafter granted Reinhard's motion for attorney's fees, and awarded him $353,607.96 in attorney's fees. The Trust filed a notice of appeal from the attorney's fees order.

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[6] The trial court also sustained the demurrer without leave to amend as to one cause of action and with leave to amend as to one cause of action. The demurrer was overruled as to the remaining nine causes of action.

III. Discussion

The Trust claims that the court abused its discretion in sustaining Reinhard's demurrer to its breach of contract and breach of the implied covenant causes of action. It also contends that the court erroneously concluded that the nonrecourse provision of the Note was not unconscionable.

A. Demurrer

1. Standard of Review

"'We treat the demurrer as admitting all material facts properly pleaded, but not contentions, deductions or conclusions of fact or law. [Citation.] We also consider matters which may be judicially noticed.' [Citation.] Further, we give the complaint a reasonable interpretation, reading it as a whole and its parts in their context. [Citation.] When a demurrer is sustained, we determine whether the complaint states facts sufficient to constitute a cause of action. [Citation.] And when it is sustained without leave to amend, we decide whether there is a reasonable possibility that the defect can be cured by amendment: if it can be, the trial court has abused its discretion and we reverse; if not, there has been no abuse of discretion and we affirm. [Citations.] The burden of proving such reasonable possibility is squarely on the plaintiff." (*Blank v. Kirwan* (1985) 39 Cal.3d 311, 318.) "[W]e disregard allegations that are . . . contradicted by the express terms of an exhibit [such as a contract] incorporated into the complaint." (*Freeman v. San Diego Assn. of Realtors* (1999) 77 Cal.App.4th 171, 178, fn. 3; *Peak v. Republic Truck Sales Corp.* (1924) 194 Cal. 782, 790; *Stoddard v. Treadwell* (1864) 26 Cal. 294, 303.)

Contract interpretation, including the question of whether a covenant should be implied, is a question of law unless there is conflicting extrinsic evidence. (*Parsons v. Bristol Development Co.* (1965) 62 Cal.2d 861, 865; *Del Taco, Inc. v. University Real Estate Partnership V* (2003) 111 Cal.App.4th 16, 22.) The SPA and the Note were fully

integrated agreements, and the parties do not contend that the interpretation of these agreements depends on extrinsic evidence.

2. Analysis

The Trust claims that the trial court should not have sustained Reinhard's demurrer to its breach of the implied covenant cause of action because "a covenant not to impair the collateral" must be implied as a term of the SPA and the Note. The Trust maintains that this implied covenant required Reinhard to "'insure a continuation' of Garden City's business and, with it, the value of the trust's collateral." In the Trust's view, the nonrecourse provisions in the Note and the SPA are "limited to a direct collection action" and do not apply to "an action for damages for bad faith impairment of collateral."[7]

Reinhard counters that the Trust cannot succeed on an implied covenant claim because the Note and the SPA restrict the Trust's remedies for any breach of contract to foreclosure on the stock. He also argues that the express provisions of the Note and the SPA preclude an implied covenant requiring him to preserve the value of the collateral. Reinhard further contends that such a covenant cannot be implied because it was not necessary to effectuate the parties' intent or to ensure that their agreement was supported by adequate consideration.

"In every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing." (*Universal Sales Corp. v. Cal. etc. Mfg. Co.* (1942) 20 Cal.2d 751, 771.) "The covenant of good faith is read into contracts in order to

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[7] Although the Trust devotes a separate section of its appellate brief to its breach of contract cause of action, as opposed to its breach of the implied covenant cause of action, its arguments in that section are completely dependent on its contentions regarding the alleged implied covenant and need not be separately addressed.

protect the express covenants or promises of the contract, not to protect some general public policy interest not directly tied to the contract's purposes." (*Foley v. Interactive Data Corp.* (1988) 47 Cal.3d 654, 690.)

"[A]s a general matter, implied terms should never be read to vary express terms. [Citations.] 'The general rule [regarding the covenant of good faith] is plainly subject to the exception that the parties may, by express provisions of the contract, grant the right to engage in the very acts and conduct which would otherwise have been forbidden by an implied covenant of good faith and fair dealing. . . . [¶] This is in accord with the general principle that, in interpreting a contract "an implication . . . should not be made when the contrary is indicated in clear and express words." [Citation.] . . . [¶] As to acts and conduct authorized by the express provisions of the contract, no covenant of good faith and fair dealing can be implied which forbids such acts and conduct. And if defendants were given the right to do what they did by the express provisions of the contract there can be no breach.'" (*Carma Developers (Cal.), Inc. v. Marathon Development California, Inc.* (1992) 2 Cal.4th 342, 374.)

"The rules which govern implied covenants have been summarized as follows: '(1) the implication must arise from the language used or it must be indispensable to effectuate the intention of the parties; (2) it must appear from the language used that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it; (3) implied covenants can only be justified on the grounds of legal necessity; (4) a promise can be implied only where it can be rightfully assumed that it would have been made if attention had been called to it; (5) there can be no implied covenant where the subject is completely covered by the contract.'" (*Lippman v. Sears, Roebuck & Co.* (1955) 44 Cal.2d 136, 142 (*Lippman*); *Third Story Music, Inc. v. Waits* (1995) 41 Cal.App.4th 798, 804 (*Waits*).)

The Trust claims that the SPA included an implied covenant obligating Reinhard personally to preserve the value of Garden City's stock. While the implied covenant of

good faith and fair dealing cannot be disclaimed and is a term of every contract (Cal. U. Com. Code, § 1302, subd. (b)), it does not follow that an obligation to preserve the collateral will be implied in every contract involving collateral. Here, the SPA explicitly provided that Reinhard had "no obligation to contribute capital to [Garden City]" and had no personal liability beyond "amounts which have been distributed to Buyer by the Company for payment to seller on the Note, as provided in the Note." The Note also explicitly provided that Reinhard had no personal liability. By explicitly absolving Reinhard of any obligation to contribute capital to Garden City and expressly releasing him from any personal liability beyond distributed funds, the SPA unambiguously excused Reinhard from any personal obligation to preserve the value of Garden City's stock.

The absence of any personal obligation to preserve the value of Garden City's stock was also supported by the SPA's express provision that "there are no representations, warranties, or commitments except as set forth herein." It is not possible to reconcile the Trust's allegation that Reinhard had impliedly covenanted to preserve the value of Garden City's stock with the SPA's express provision that Reinhard had made "no . . . commitments" other than his express covenants, which did not include any obligation to preserve the value of Garden City's stock. All of these express provisions of the SPA rebut the Trust's claim that Reinhard had an implied obligation to preserve the value of Garden City's stock.

The Trust contends that the "no . . . commitments" language in the SPA was simply an "integration clause" that did not preclude the implication of an implied covenant to preserve the value of Garden City's stock. The Trust claims that an integration clause *cannot* preclude the implication of an implied covenant, and, as support for this proposition, it cites this court's decision in *Amtower v. Photon Dynamics, Inc.* (2008) 158 Cal.App.4th 1582 (*Amtower*). The issue in *Amtower* was whether defendant Photon could recover its attorney's fees from the plaintiff. The plaintiff's tort action had

arisen from an "Affiliate" agreement that did not contain an attorney's fees clause. Defendant Photon claimed that it was entitled to recover its attorney's fees because the affiliate agreement had "effectively incorporated the terms" of an associated "Merger" agreement, which did contain an attorney's fees clause, but to which the plaintiff was not a party. (*Amtower*, at pp. 1605, 1606.)

This court noted that both the affiliate agreement and the merger agreement referenced each other and contained integration clauses. The merger agreement's integration clause provided: "'This Agreement and the other agreements referred to herein set forth the entire understanding of the parties hereto relating to the subject matter hereof . . . .'" (*Amtower, supra*, 158 Cal.App.4th at p. 1606.) The affiliate agreement was one of the agreements referred to in the merger agreement. (*Amtower*, at p. 1606.) The affiliate agreement, in turn, referred to the merger agreement and contained an integration clause that provided: "'This Affiliate Agreement, the [Merger Agreement], and any Shareholder Agreement or Noncompetition Agreement between Shareholder and Parent collectively set forth the entire understanding of [Photon] and Shareholder relating to the subject matter hereof and thereof and supersede all other prior agreements and understandings between [Photon] and Shareholder relating to the subject matter hereof and thereof.'" (*Amtower*, at p. 1606.)

Photon contended that the affiliate agreement's integration clause incorporated the merger agreement's attorney's fees clause into the affiliate agreement. (*Amtower, supra*, 158 Cal.App.4th at p. 1607.) This court rejected Photon's contention. "To impliedly incorporate an external document by reference, the subject document must contain some clear and unequivocal reference to the fact that the terms of the external document are incorporated." (*Amtower*, at p. 1608.) As the affiliate agreement did not clearly incorporate the merger agreement's terms, this court held that the merger agreement's attorney's fees clause did not apply to an action arising from the affiliate agreement. (*Amtower*, at pp. 1608-1609.)

Nothing in *Amtower* even remotely suggests anything that supports the proposition for which the Trust cites *Amtower*. The integration clause in the affiliate agreement bears no resemblance to the "no . . . commitments" language in the SPA.[8] This court did not hold that integration clauses in general cannot preclude the implication of additional covenants. In fact, this court held that the integration clause in *Amtower* did not itself incorporate additional covenants.

The Trust also relies on *Lippman*, but its reliance is misplaced. In *Lippman*, the lease provided that the amount of the lessee's rental payments to the lessor depended on the lessee's sales from its retail business on the leased premises. (*Lippman*, *supra*, 44 Cal.2d at pp. 138-139.) The lease explicitly provided that the purpose of the lease was for the leased premises to be used for the lessee's retail business. (*Lippman*, at p. 139.) During the lease period, the lessee discontinued its retail business on the leased premises and began using the leased premises solely for storage. The lessor filed an action against the lessee alleging that the lessee had breached its implied covenant to continue its retail business on the leased premises. (*Lippman*, at pp. 139-140.) The California Supreme Court noted that "the court may imply such a covenant only where it is a natural implication from the language used or is indispensable to effectuate the expressed intention of the parties." (*Lippman*, at p. 145.) Because the lease based the rental amount

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[8] The "no . . . commitments" language appears in section 18.6 of the SPA, which is entitled "Entire Agreement; Binding Effect." Section 18.6 reads, in its entirety: "This Agreement (including the Exhibits and Schedules attached hereto) constitutes the entire agreement among the parties, and supersedes any and all prior negotiations, understandings, and agreements among the parties, relating to the subject matter hereof, and there are no representations, warranties, or commitments except as set forth herein. This Agreement may be amended only by an instrument in writing executed by the parties hereto affected by the amendment. This Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, legal representatives, successors, and permitted assigns."

on a percentage of the lessee's business's sales, "a covenant to remain in business may be implied . . . ." (*Lippman*, at pp. 144-145.)

Lippman is readily distinguishable. The essential premise for *Lippman*'s holding that there was an implied covenant to continue the business on the leased premises was that the contract *expressly* based the rental amount on the sales from the business. That essential premise is entirely lacking here. Neither the SPA nor the Note based Reinhard's monetary obligations to the Trust on Garden City's revenues or the value of its stock. A personal obligation to preserve the value of Garden City's stock does not arise by "natural implication" from the language of the SPA and cannot be said to be indispensable to the parties' expressed intent. The SPA *explicitly* shields Reinhard from personal liability and *expressly* rejects any unmentioned obligations, thereby expressing the parties' intent to shield Reinhard from any additional obligations. The bases for *Lippman*'s holding are lacking here.

Nippon Credit Bank v. 1333 North Cal. Boulevard (2001) 86 Cal.App.4th 486 (*Nippon*) is equally unsupportive of the Trust's contentions. *Nippon* was a *tort* action for waste brought by a lender against a borrower. The borrower's loan, which was secured by a deed of trust on an office complex, was a nonrecourse loan that explicitly obligated the borrower to pay the property taxes on the office complex. (*Nippon*, at pp. 489-490.) After the lender refused to change the interest rate on the loan, the borrower retaliated by refusing to pay the property taxes and defaulting on the loan payments. (*Nippon*, at pp. 490-491.) The lender foreclosed on the property and also brought a tort action for waste against the borrower. (*Nippon*, at pp. 499-500.) It alleged that the borrower had refused to pay the taxes with the intent to harm the lender. The lender recovered compensatory and punitive damages, and the borrower appealed. (*Nippon*, at p. 493.) The Court of Appeal rejected the borrower's claim that, due to the nonrecourse nature of the loan, it could not be held personally liable in tort for waste. (*Nippon*, at pp. 495-496.) The court likened the nonpayment of property taxes to physical damage to the property,

and it held that a nonrecourse borrower could be held liable in tort for willfully damaging the property. (*Nippon*, at p. 496.)

The Trust ignores the fact that *Nippon* was a *tort* action for *willful* damage to the property securing a nonrecourse loan. Here, the Trust did not allege that Reinhard had *tortiously* harmed the value of Garden City's stock.[9] *Nippon* was not a contract case, and it had no occasion to consider whether the borrower's nonrecourse loan included any implied covenant, particularly since the loan had an express covenant requiring the borrower to pay the real property taxes.[10]

The Trust also relies on *Flying Tiger Line, Inc. v. U. S. Aircoach* (1958) 51 Cal.2d 199 (*Flying Tiger*), but it too is inapposite. Fritz Hutcheson owned U.S. Aircoach, and U.S. Aircoach owed money to Flying Tiger Line, Inc. (FTL). Hutcheson agreed to pledge his stock in U.S. Aircoach as security for U.S. Aircoach's debts in return for FTL extending additional credit to U.S. Aircoach. The pledge agreement provided that Hutcheson would not be "personally responsible" for U.S. Aircoach's debt to FTL. (*Flying Tiger*, at p. 200.) Hutcheson, who was the alter ego of U.S. Aircoach, fraudulently misappropriated U.S. Aircoach's funds, which caused U.S. Aircoach to become insolvent. FTL brought a successful action against Hutcheson and U.S. Aircoach to recover the debt. (*Flying Tiger*, at pp. 200-202, 204.)

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[9] The Trust's first amended complaint alleged a cause of action for intentional or negligent impairment of collateral. The superior court granted summary adjudication on that cause of action on statute of limitations grounds, and the Trust does not challenge that ruling on appeal. The Trust's first amended complaint also alleged a cause of action for breach of fiduciary duty. Reinhard's demurrer to that cause of action was sustained with leave to amend, but the Trust did not file an amended complaint. The Trust does not challenge that ruling on appeal. It alleged no other tort causes of action in its first amended complaint, which is the operative pleading in this appeal.

[10] *Cornelison v. Kornbluth* (1975) 15 Cal.3d 590 (*Cornelison*), which is also cited by the Trust, is distinguishable on the same ground. The primary issue that was addressed in *Cornelison* was the viability of a *tort* action for waste. (*Cornelison*, at pp. 597-598.)

On appeal, Hutcheson claimed that the provision in the pledge agreement barred his personal liability on the debt. (*Flying Tiger*, *supra*, 51 Cal.2d at pp. 202-203) The California Supreme Court rejected his contention. Hutcheson's status as the alter ego of U.S. Aircoach necessarily made him personally liable for U.S. Aircoach's debts notwithstanding the language in the pledge agreement. The language in the pledge agreement did not give Hutcheson a "'license to steal'" and release him from liability for fraud because it had to be interpreted in light of the implied covenant of good faith and fair dealing that was necessarily part of the pledge agreement. (*Flying Tiger*, at pp. 203-204.)

What the Trust fails to note about *Flying Tiger* is that FTL's recovery from Hutcheson was based on the fact that he was U.S. Aircoach's alter ego and had fraudulently taken all of U.S. Aircoach's funds. Indeed, it is evident that FTL's action against Hutcheson was not a *contract* action, but a tort action for fraud, as Hutcheson was not contractually liable for U.S. Aircoach's debt. As we have noted above, the Trust's causes of action were based on contract, and the Trust did not allege that Reinhard had defrauded it. Nor did the Trust attempt to show that Reinhard was Garden City's alter ego. Consequently, *Flying Tiger* provides no support for the Trust's causes of action against Reinhard.

"'The courts cannot make better agreements for parties than they themselves have been satisfied to enter into or rewrite contracts because they operate harshly or inequitably. It is not enough to say that without the proposed implied covenant, the contract would be improvident or unwise or would operate unjustly. Parties have the right to make such agreements. The law refuses to read into contracts anything by way of implication except upon grounds of obvious necessity.'" (*Waits*, *supra*, 41 Cal.App.4th at p. 809.) A covenant will be implied only where necessary to effectuate the parties' intent or to prevent the agreement from being illusory due to the lack of consideration. (*Waits*, at p. 808.)

Here, the SPA and the Note unambiguously expressed the parties' intent that Reinhard have no personal liability and no personal obligations other than as expressly set forth. The SPA was indisputably supported by adequate consideration, as it obligated Reinhard to pay $1 million to the City, to assume the Trust beneficiaries' substantial financial obligations to the landlord and to indemnify them, and to pay over $7 million to the Trust, at its option, if the Trust exercised the "put option," in addition to making regular payments under the nonrecourse provisions of the Note. Under these circumstances, a covenant to preserve the value of Garden City's stock cannot be implied. Since the SPA and the Note contained no implied or express covenant requiring Reinhard to preserve the value of Garden City's stock, the superior court did not abuse its discretion in sustaining Reinhard's demurrer without leave to amend to the Trust's causes of action for breach of the implied covenant and breach of contract.

B. Unconscionability

The Trust challenges the trial court's finding that the nonrecourse provision of the Note was not unconscionable.

1. Trial Evidence

The sole target of the Trust's unconscionability contention was section 2 of the Note. Section 2 of the Note provided that the Note was "nonrecourse against the Maker [Reinhard] and the sole recourse of the Trust shall be against the Collateral." It further provided: "If as a result of such foreclosure and sale of the Collateral under the Pledge Agreement, a lesser sum is realized therefrom than the amount then due and owing under this Note and the Pledge Agreement, Maker shall have *no personal liability* therefor and the Trust will never institute any action, suit, claim or demand at law or in equity against Maker for or on account of such deficiency" with the exception that Reinhard "shall be personally liable only for amounts, if any, distributed to Maker by [Garden City] for

payment to the Trust on this Note, if Maker fails to make such payments to the Trust." (Italics added.)

The Note's nonrecourse clause was the result of extended negotiations between the Trust and Reinhard. From the very beginning of these negotiations, Reinhard made it unmistakably clear that he was only interested in a nonrecourse agreement that shielded him from personal liability. He testified at trial that he would "[a]bsolutely not" have been interested in purchasing the Garden City stock without the nonrecourse provision. Reinhard's attorney also made it clear to the Trust's attorney from the start of their negotiations that Reinhard was "absolutely adamant that the note would be nonrecourse or there would be no deal." Reinhard insisted that the note bar "personal recourse against its maker . . . ." "There was no negotiating room on that point." "[A]nybody who thinks that I would assume a jot of personal liability for a business that I knew nothing about wouldn't know me very well." The Trust's beneficiaries were aware of Reinhard's insistence on a nonrecourse note from the outset, and they had multiple attorneys advising them throughout the negotiations with Reinhard.

The Trust presented evidence at trial aimed at demonstrating that Reinhard's negotiating tactics were oppressive. In the trustee's opinion, as the negotiations progressed, Reinhard's proposals became "not only worse" but "beyond ridiculous." "The agreements were changed, changed again and changed again, and always so that the shareholders' interests were diminished, capabilities of enforcing the agreement would diminish." One of the Trust's attorneys testified that the Trust had "no bargaining power" because "[t]he asset was going to evaporate . . . on October 18th, . . . it was going to have no value."

The Trust produced testimony that it would not have agreed to the nonrecourse term if there had been no deadline. The Trust's beneficiaries testified that they were not happy with the terms of the SPA, but they felt they had no reasonable alternatives. "We had options earlier in the year. But there were no options at that time. It was too late.

No one would be able to conduct sufficient due diligence in that time frame." They understood that Garden City's cardroom license would disappear if they did not meet the deadline, and then Garden City would be "out of business." While some of the beneficiaries conceded that $23.4 million was "a fair deal" for the stock, others thought it was a "fire sale" that was "unfair[,]" as the stock was worth much more.[11] One of the Trust's attorneys told a beneficiary who did not want to sign the SPA that he "would be an idiot if I didn't sign it because I was going to wind up with nothing." The beneficiaries waited until the last possible time to sign the SPA because they were hoping for an extension of time from the Chief of Police and the State. No extension was forthcoming.

2. Trial Court's Findings

The trial court concluded that it was "fairly clear[]" that there was no procedural unconscionability. It found that, from the outset, it was "an inviolate bottom-line deal breaker element throughout all of the negotiations" that Reinhard would have no personal liability. Although there was "an inequality of bargaining power," this did not establish procedural unconscionability because "there was real negotiation and there was meaningful choice" and "there certainly is no surprise." "In short, although there are elements of oppression because of the unequal bargaining posture of the parties, I believe that that inequality of bargaining power didn't contaminate the actual negotiations. There was meaningful choice." "Now, I think there certainly is some evidence of oppression, unequal bargaining position. Everybody has to admit that. There's no evidence of surprise. A nonrecourse provision is not unusual."

As to substantive unconscionability, the court found that it was "not unreasonable that Mr. Reinhard would insist upon a nonrecourse provision in this circumstance, and it

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[11] Garden City's obligations included the $9 million or $10 million obligation to its landlord, the $5 million fine owed to the City, and significant tax liabilities. The total value of the purchase to the Trust beneficiaries exceeded $40 million.

certainly wasn't unexpected because Mr. Nicoletti [Garden City's attorney] himself, according to the evidence, proposed it." The nonrecourse provisions did not "shock [the court's] conscience" because the Trust had a meaningful remedy so long as Garden City prospered, which is what both the Trust and Reinhard expected when they entered into the contract.

"[Reinhard] didn't need Garden City. They [the Trust] needed him. And they got the 17 million dollars in relief that they desperately needed. He got a business that should have been and at that time was a going concern that appeared to be profitable. So both sides benefitted. [¶] For me to come in after the fact and artificially distort the agreement the parties made at the time would be to reallocate the risk that they thought each side was bearing appropriately and really to violate the rule that when parties negotiate and reduce it to writing in a meaningful way with representation on both sides, and time to consider, and do so voluntarily, although there may be elements of economic duress, the court ought not to intervene as a general proposition. [¶] So, therefore, I find that the contract should not be rewritten by this court; that no particular term . . . is unconscionable."

3. Standard of Review

"[W]hile unconscionability is ultimately a question of law, numerous factual inquiries bear upon that question. [Citations.] The business conditions under which the contract was formed directly affect the parties' relative bargaining power, reasonable expectations, and the commercial reasonableness of the risk allocation as provided in the written agreement. To the extent there are conflicts in the evidence or in the factual inferences which may be drawn therefrom, we must assume a set of facts consistent with the court's finding [on] unconscionability if such an assumption is supported by substantial evidence." (*A & M Produce Co. v. FMC Corp.* (1982) 135 Cal.App.3d 473, 489.)

4. Analysis

"'[U]nconscionability has both a "procedural" and a "substantive" element,' the former focusing on '"oppression"' or '"surprise"' due to unequal bargaining power, the latter on '"overly harsh"' or '"one-sided"' results. [Citation.] 'The prevailing view is that [procedural and substantive unconscionability] must *both* be present in order for a court to exercise its discretion to refuse to enforce a contract or clause under the doctrine of unconscionability.' [Citation.] But they need not be present in the same degree. 'Essentially a sliding scale is invoked which disregards the regularity of the procedural process of the contract formation, that creates the terms, in proportion to the greater harshness or unreasonableness of the substantive terms themselves.' [Citations.] In other words, the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa." (*Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, 114.) "The critical juncture for determining whether a contract is unconscionable is the moment when it is entered into by both parties—not whether it is unconscionable in light of subsequent events." (*American Software, Inc. v. Ali* (1996) 46 Cal.App.4th 1386, 1391.)

We look first at procedural unconscionability. "The procedural element of the unconscionability analysis concerns the manner in which the contract was negotiated and the circumstances of the parties at that time." (*Gatton v. T-Mobile USA, Inc.* (2007) 152 Cal.App.4th 571, 581.) "Procedural unconscionability focuses on the manner in which the disputed clause is presented to the party in the weaker bargaining position. When the weaker party is presented the clause and told to 'take it or leave it' without the opportunity for meaningful negotiation, oppression, and therefore procedural unconscionability, are present." (*Szetela v. Discover Bank* (2002) 97 Cal.App.4th 1094, 1100.) "The procedural element of an unconscionable contract generally takes the form of a contract of adhesion, which, imposed and drafted by the party of superior bargaining

strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it." (*Discover Bank v. Superior Court* (2005) 36 Cal.4th 148, 160, internal quotation marks omitted.) "The procedural element of unconscionability involves oppression and surprise. [Citation.] Oppression arises when the parties have unequal bargaining power, leading to no real negotiation and lack of meaningful choice. Surprise may arise when challenged terms are hidden in a prolix printed form drafted by a party in a superior bargaining position." (*Baker v. Osborne Development Corp.* (2008) 159 Cal.App.4th 884, 894, internal quotation marks omitted.)

"[T]here are degrees of procedural unconscionability. At one end of the spectrum are contracts that have been freely negotiated by roughly equal parties, in which there is no procedural unconscionability. Although certain terms in these contracts may be construed strictly, courts will not find these contracts substantively unconscionable, no matter how one-sided the terms appear to be. [Citation.] Contracts of adhesion that involve surprise or other sharp practices lie on the other end of the spectrum. [Citation.] Ordinary contracts of adhesion, although they are indispensable facts of modern life that are generally enforced [citation], contain a degree of procedural unconscionability even without any notable surprises, and 'bear within them the clear danger of oppression and overreaching.'" (*Gentry v. Superior Court* (2007) 42 Cal.4th 443, 469.) "[A] finding of procedural unconscionability does not mean that a contract will not be enforced, but rather that courts will scrutinize the substantive terms of the contract to ensure they are not manifestly unfair or one-sided." (*Ibid.*)

The trial court expressly found that the parties' bargaining positions were unequal, but it also concluded that there *was* "real negotiation" and "meaningful choice" and *no* "surprise." Reinhard contends that the trial court impliedly found that there was *no* procedural unconscionability. The Trust characterizes the trial court's finding as one of "insufficient procedural unconscionability." In our view, the trial court's finding of unequal bargaining positions, but no other elements of procedural unconscionability,

amounted to a conclusion that there was a minimal amount of procedural unconscionability.

The Trust does not directly challenge the sufficiency of the evidence to support the trial court's underlying factual findings, and the record amply supports these findings. While the Trust tried to prove that Reinhard's negotiating tactics deprived it of meaningful choice, the trial court plainly did not credit this evidence. Reinhard's evidence, on the other hand, established that the Trust was well aware of his insistence on a nonrecourse clause from the outset. Since the Trust was negotiating with multiple potential buyers when it learned of Reinhard's insistence on a nonrecourse provision, it had a meaningful choice to reject him as a potential buyer if it was unwilling to agree to the nonrecourse provision. The fact that Reinhard insisted on a nonrecourse provision from the outset also established the absence of surprise. The length and complexity of the negotiations provided ample support for the court's finding that there had been "real negotiation." Based on this evidence, the trial court reasonably concluded that there was only a minimal level of procedural unconscionability, as the sole indicator of procedural unconscionability was the unequal bargaining positions of the parties.

Because the parties did have unequal bargaining positions, and therefore there was a minimal level of procedural unconscionability, we must proceed to consider whether the nonrecourse provision in the Note was substantively unconscionable. "Substantive unconscionability focuses on the terms of the agreement and whether those terms are so one-sided as to shock the conscience. [Citation.] A contractual provision that is substantively unconscionable may take various forms, but may generally be described as unfairly one-sided." (*Nyulassy v. Lockheed Martin Corp.* (2004) 120 Cal.App.4th 1267, 1281, internal quotation marks omitted.) "In sum, a wide variety of attributes may affect the determination of substantive unconscionability. But the key factor is lack of mutuality. And the determinative question is whether the contract terms are so harsh or one-sided that they lack basic fairness." (*Abramson v. Juniper Networks* (2004) 115

Cal.App.4th 638, 658.) "Substantive unconscionability turns not only on a one sided result, but also on an absence of justification for it." (*Carboni v. Arrospide* (1991) 2 Cal.App.4th 76, 84, internal quotation marks omitted.)

"The phrases 'harsh,' 'oppressive,' and 'shock the conscience' are not synonymous with 'unreasonable.' Basing an unconscionability determination on the reasonableness of a contract provision would inject an inappropriate level of judicial subjectivity into the analysis. 'With a concept as nebulous as "unconscionability" it is important that courts not be thrust in the paternalistic role of intervening to change contractual terms that the parties have agreed to merely because the court believes the terms are unreasonable. The terms must shock the conscience.'" (*Morris v. Redwood Empire Bancorp* (2005) 128 Cal.App.4th 1305, 1322-1323.)

The terms of the parties' agreement are not so one-sided that they shock the conscience or lack basic fairness. The Note's nonrecourse provision cannot be viewed in isolation. While the nonrecourse provision meant that Reinhard would not be personally liable for payments on the Note, those payment obligations were secured by Garden City's stock. At the time the parties entered into their agreement, that stock was the only thing of value that Reinhard received in exchange for his acceptance of millions of dollars in obligations to the City, the landlord, and the Trust. Hence, at that time, both parties clearly contemplated that the stock was a valuable asset. If Reinhard did not fulfill his payment obligations under the Note, the Trust could foreclose on that valuable asset. Given the investment that Reinhard was making to acquire the stock, the parties could reasonably expect that he would not risk losing this asset by defaulting on his payment obligations.

Furthermore, Reinhard's effort to limit his personal liability in this manner was justified. Although Reinhard was an experienced real estate developer, he knew nothing about the gambling industry in general or Garden City's business in particular. Garden City may have had a history of profitability, but it also had a troubled history of criminal

activities and a deteriorating physical facility, and was facing increased competition from another cardroom. By purchasing Garden City, Reinhard was assuming millions of dollars in debt and indemnifying the Trust's beneficiaries against those debts, for which they had been personally liable. The SPA also obligated Reinhard to pay over $7 million to the Trust, at its option, within seven months of the purchase, on top of the required payments on the Note. In return, Reinhard was receiving stock that was entirely dependent on the continued validity of Garden City's gambling license, which, as had been so recently demonstrated, could be revoked by the City and the State.

Under these circumstances, the inclusion of a nonrecourse provision in the Note was a justifiable and fair means of allocating the risks between the parties. The parties believed that Garden City would prosper, but Reinhard had good reason to be concerned about its prospects. If Garden City prospered, the Trust could be assured that Reinhard would not risk the loss of the business by defaulting on his payment obligations. On the other hand, if Garden City turned out to be a poor investment, the Trust could foreclose on the stock, and Reinhard's overall exposure would be limited to his initial investment of cash, and any funds due under the "put option." The Trust would not be in a worse position than it had been initially, as it would regain the stock after having reduced its liabilities, and with the benefit of any payments that had been made on the Note and under the "put option."

The minimal level of procedural unconscionability and the absence of any significant substantive unconscionability demonstrate that the nonrecourse provision of the Note was not unconscionable. Accordingly, the trial court did not err in rejecting the Trust's unconscionability contention.

IV. Disposition

The judgment and the attorney's fees order are affirmed.

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Mihara, J.

WE CONCUR:

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Elia, Acting P. J.

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McAdams, J.